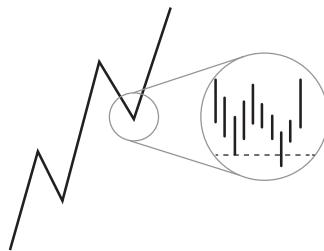


## PULLBACK, BUYING SUPPORT OR SHORTING RESISTANCE



### Trade Type

Trend continuation.

**Concept** Pullbacks are probably the most important structural feature of trends. For many traders, pullbacks are the quintessential with-trend trade, using the countertrend pullback to position in the larger trend at an advantageous price. The broad term *pullback* encompasses a large number of specific patterns: flags, pennants, wedges, continuation triangles, and many others, but the exact shape of the pattern is not that important. In reality, these are all functionally the same—they are continuation patterns in trends. It is not necessary, nor is it constructive, to have separate trading plans for each of these patterns. Understand what the pattern is and what it does, and trade it accordingly.

**Setup** The most important condition for this trade is that the market must be trending. Though it is not always possible to separate trending from nontrending environments with precision, many losing trades are the result of attempting pullbacks in nontrending environments. Objective tools to identify trends have been discussed in Chapter 3, but the problem can be reduced to whether the setup leg preceding the pullback shows good momentum—it must be a move that should see continuation after consolidation.

At the risk of oversimplifying, if the market is in an established trend, the preceding setup leg should be at least as strong as previous trend legs in the same direction. In other words, it should not break the pattern of the trend and should not show momentum divergence. Pullback trades are also possible on trend changes or following breakouts of trading ranges, though this more properly falls under the Anti trade category. In these cases, there will be no established trend, but the setup leg should show a distinct change of character compared to the preceding environment. Whether in an established trend or at the beginning of a new potential trend, the same condition applies: the setup leg should suggest momentum in the market that must be resolved through an attempted third leg (impulse-retracement-impulse) continuation.

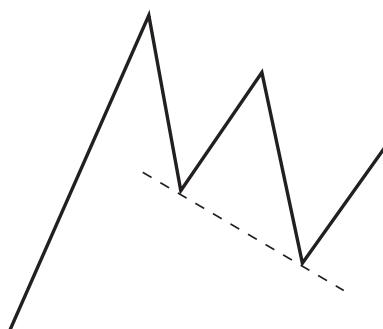
One useful way to approach trend trades is to consider conditions that would contradict this trade, which are the standard preconditions for countertrend trades. In the absence of any of these (e.g., momentum divergence, overextension on higher time frames, etc.), with-trend trades are fully justified.

Different markets have different characters with respect to the integrity, length, and strength of trends—some markets trend better than others. For instance, it is somewhat unusual for most intraday index products to have trends that extend more than three legs, but individual equities, especially if they have had unusual news that day, may trend much further. Some commodities, such as meat products, do not tend to trend well, but petroleum products and grains are capable of significant, extended trends with many clean trend legs. On longer time frames, interest rate products, and currency rates often show multiyear trends. In general, there is an old rule of thumb that says that larger markets (in terms of nominal value) trend better; though this is difficult to prove quantitatively, it is a useful guideline to keep in mind. Certainly, extraordinary conditions do occur where a market makes a move that is out of all proportion to historical precedents. Your trading plan should allow you to participate in those moves with at least partial positions, but these unusual moves should not be the main focus of your plan.

Once the main prerequisites of a trending market with no contradictory conditions are satisfied, we turn to the geometry of the pullback pattern itself. Good pullbacks almost always show reduced activity (smaller ranges for individual bars) and the absence of strong countertrend momentum. This is why traditional technical analysis suggests that volume should be lighter in pullbacks—they are zeroing in on the (valid) fact that trading activity should be less on the pullbacks. In many cases, pullbacks *will* have lighter volume, but this is not the distinguishing feature. In all cases the best pullbacks have reduced activity, which is visible on the lower time frame, in price action, and in the lack of strong countertrend momentum on the trading time frame—but necessarily lower volume per se.

Last, it also makes sense to be responsive to developing market structure, even after the trade is initiated. A pullback may emerge at a spot where the trade was justified, but developing price action may suggest that the trend is losing integrity. If this happens, it is not necessary to hold the trade to the original stop-loss level. It is often advisable to scratch the trade, exiting for a small win or loss, and to wait for better opportunities. A good trading plan will allow flexibility and will encourage the trader to be responsive to developing market conditions.

**Trigger** The actual entry for this trade is buying against the support level near the bottom or selling short against the resistance near the top of the pullback. There is an important trade management issue to consider, as Figure 6.3 shows: support and resistance levels usually *slope* in these patterns. One of the advantages of buying against support is that, usually, your risk is fairly clearly defined, but, in the case of buying into pullbacks, price can decline (or rally, in a pullback against a downtrend) much further than expected while the pattern remains valid. It can be difficult to define the risk on a position entered against a sloping support or resistance level, but it does not make sense

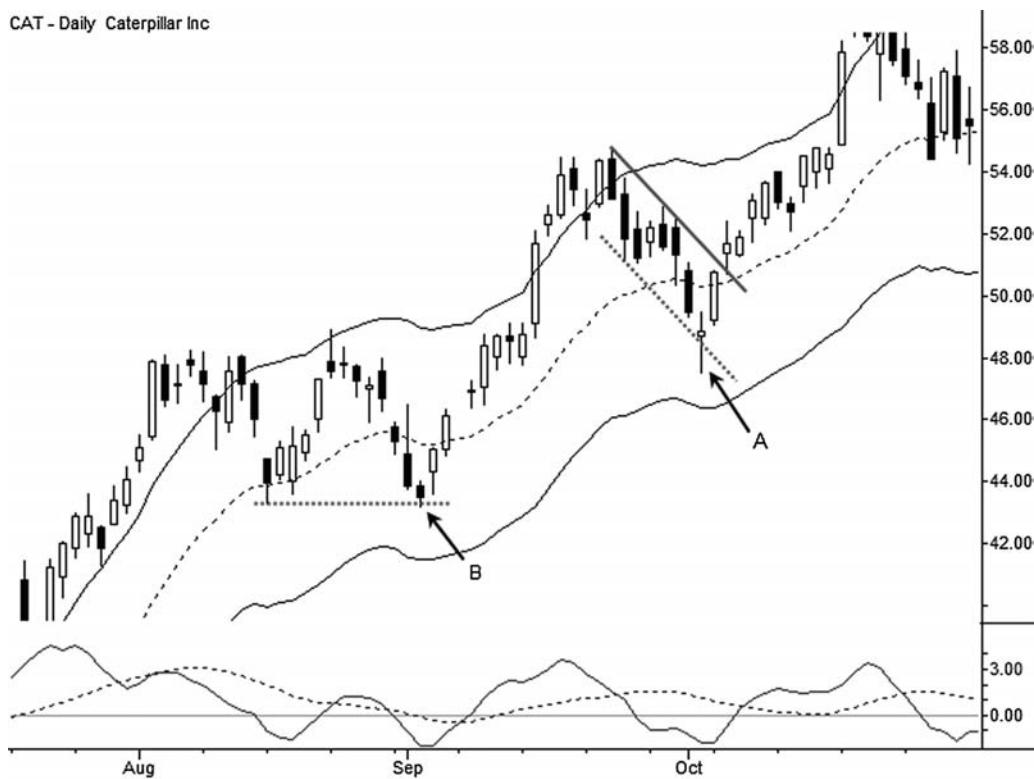


**FIGURE 6.3** Support in a Pullback Is Usually Sloping, Not Flat

to exit a trade that is still within the sloping level. Having the level itself is not enough; it is also important to have a clear trigger against that level to support the actual entry.

There are two ideal triggers. In the first, the market has defined a clean pullback. Sometimes it is possible to draw a trendline on both sides of the pullback, but, barring that, a parallel trend channel (see Chapter 3) can be used. The entry trigger is a failure of this trend line or channel, followed by an immediate reversal; that is, the line is penetrated, but prices recover back above the trend line within a few bars. Conceptually, what has happened is that traders buying into the pullback against the support level have been washed out of the market by the drop below that support. Note that this will often coincide with a lower time frame climax, though this is usually clear from the trading time frame and it is not necessary to explicitly examine lower time frames in most cases. The bar marked A in Figure 6.4 shows an example of this entry in Caterpillar, Inc. (NYSE: CAT). The single candle with a long shadow below the support at the bottom of the flag is indicative of a small climax move on the lower time frame. This entry has the advantage of excellent trade location; some of these will actually be very near the low tick of the pullback. The only real disadvantage of this entry is that considerable experience may be required to read the market correctly at these spots, and, even on relatively long time frames, you have to pay attention because the exhaustion below support will happen on a single bar. This is a skilled trader's tool, not a buy-and-forget entry.

The second entry trigger is actually buying against the support at the bottom of the pullback, for example, at point B in Figure 6.4. It is always possible to find examples of this entry on historical charts, but it can be considerably more difficult to make this trade in real time. Stop placement is problematic because the support can drop, washing weak-hand longs out of the market; the recovery from this fakeout is actually the previously discussed entry. Why put yourself in the position of being the weak trader who is washed out of the market? However, if you are executing some variation of this buying against support plan (or shorting against resistance), it is essential to limit your loss and your risk on these trades; some of them will drop support and trade lower with a vengeance. Note also that this entry has much in common with the tools and techniques



**FIGURE 6.4** Two Entries in Pullbacks in an Uptrend

for simply trading against any support and resistance level—the same ideas, risks, and caveats apply.

One pattern to avoid is buying against multiple (three or more) tests of support in a pullback, as this pattern is often more indicative of an impending failure. The operative concept here is usually lower highs into support, as successive bounces find fewer willing buyers. This is not to say that retracement patterns that show this characteristic never work out, but, on balance, they are lower-probability plays. Most traders will have the most success if they restrict their operations to the best possible trades. The best pullbacks are pauses in strong trends; there should be enough interest in the market that the pullback does not languish too long near support or resistance.

**Stop** There are basically two schools of thought on stop placement in general. Many traders want to put the stop as close to the pattern as possible, with the idea that doing so minimizes the size of losing trades. This is correct as far as the magnitude of the losses goes, but there are two other points to consider: First, trades should be sized so that every loss is equivalent; there is no such thing as a “low risk” trade. (Some types of

trades may be traded with different levels of risk, but, even then, risk levels should be consistent for all trades of that type.) Second, and more importantly, very close stops have a higher probability of being hit. When the probability of the loss is considered, a very tight stop often is a much larger loss in terms of expected value than a farther stop.

My preference is to put stops farther away from the pattern, and to introduce a small random “jitter” element to stop placement. One common mistake is to put your stop where everyone else puts theirs, because markets tend to seek out those stop levels. If you put yours a few ticks or cents beyond the obvious levels, you may still be swept out if there is extra volatility beyond the level, but this is an unavoidable risk of trading. The best we can do is to minimize it with intelligent stop placement. Figures 6.5 and 6.6 show several pullback trades with both near and far stop levels marked; realize that these are well-chosen examples of perfect entries, and perfect entries will rarely occur in actual trading. Again, these are only guidelines, and active management is important. Stops may be tightened dramatically a few bars into the trade, and the trade may also be managed with a time stop.



**FIGURE 6.5** Three Idealized Pullback Entries in the EURGBP (One Long and Two Short) with Near and Far Stop Levels



**FIGURE 6.6** Three Pullback Entries in Sugar Futures with Near and Far Stop Levels

**Profit Target** The most conservative profit target is at the previous pivot high of the setup leg for long traders, or at the low of the setup leg for shorts. (See Figure 6.7.) Many traders who focus on pullbacks will bid or offer (for short or long trades) part of their positions at the level, and are prepared to exit more of the position if the market runs into trouble there. These levels are often cleared easily, but there can be considerable volatility as some traders exit positions and others look to enter on breakouts beyond the level. The difference of opinion and two-sided trading in these spots can lead to unusual activity, but the strongest trends will continue past this level, extending into another leg. A good exit plan will allow for the possibility of taking partial profits while holding on to part of the position for a possible extension into further trend legs.

Another common target is the *measured move objective (MMO)*, which is calculated by taking the length of the setup leg (AB in Figure 6.8), adding that number to the pivot point marked C, and expecting the CD leg to be approximately the same length as the AB leg. There is no magic to this method. There is no mystical force at work here; the operative concept is that markets tend to trade with a fairly consistent level of volatility, and the MMO simply targets the approximate level at which we could expect the next



**FIGURE 6.7** Three Idealized Entries in U.S. Steel Corporation (NYSE: X) with Conservative Profit Targets Marked

swing to terminate based on the prevailing volatility levels and the average swing sizes of the market. Rather than treating this as an exact level, consider it a zone and give some consideration to what the correct course of action would be if the market stalls somewhere near this area. In general, the correct plan would be to take partial or complete profits even though the trade had not quite reached the target.

Last, it is also possible to manage pullback trades using risk multiples as profit targets, for instance, taking partial profits at one or two times ( $1\times$  or  $2\times$ ) the initial risk on the trade. This is a solid plan, but it probably also makes sense to incorporate information from the conservative and MMO profit targets, as they are based on the reality of market structure and volatility-driven relationships. For instance, if the first  $1\times$  risk profit target is a little beyond the conservative previous swing target, it might be a good idea to move the target to the conservative target. However, if you are trading the  $1\times$  plan and find that your first target is significantly beyond the conservative target, an adjustment might skew the reward/risk ratio significantly. These are the types of issues that must be considered within a comprehensive trading plan.



**FIGURE 6.8** The MMO Price Target for the First Pullback Trade in X

**Comments** We will look at several variations of this trade, but the concept of using pullbacks in trending markets is one of the most robust discretionary trading techniques. It uses the normal pattern of a trending market (impulse-retracement-impulse) to position at attractive prices in the trend. Trading these patterns successfully is not as easy as might be expected. One challenge is assessing the strength of the trend while looking for that fine line between a very strong market and one that is overextended, perhaps primed for reversal. Trades in the latter market are much more likely to fail and result in losses, so being able to discriminate between the two environments is an essential trading skill. All of the information in the sections on trend structure must eventually be considered in trading these patterns and incorporated into your trading plan. Much of this can be quantified, but some traders will be more comfortable using much of this information on a subjective, almost subconscious, level.

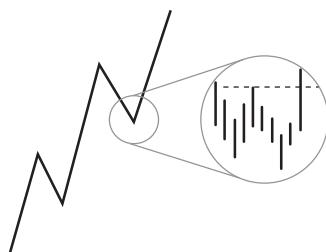
Another potential challenge is in the timing of the entry. Because pullbacks often have many of the characteristics of small trading ranges, price action within pullbacks tends to be more random and it can be difficult to time the entry point with confidence. In addition, pullbacks are actually contratrend lower time frame trends, so early entries

can result in losses if the lower time frame trend is still in control. The third challenge is stop placement. The general idea with stop placement is to avoid the noise and to place stops at a level that would prove the trade incorrect. Finding this point in pullbacks can be a little more difficult; the lower time frame trends sometimes continue further than expected, and conservative stops can be hit at exactly the wrong point. In fact, one of these failures is so common that it deserves separate consideration under the category of complex pullbacks.

Despite all of these potential issues, many traders will find that pullbacks offer some of the most attractive and consistent trading opportunities. A profitable trading plan can be built around this one trade, though an awareness of trend termination patterns will inform your perspective and help you manage losing trades. The next setup looks at an entry that combines the power of the pullback with the direction of momentum on the shortest time frames.

### **PULLBACK, ENTERING LOWER TIME FRAME BREAKOUT**

---



#### **Trade Type**

Trend continuation and breakout blend.

**Concept** This trade setup times the entry into the pullback by using the momentum of a lower time frame breakout so that the trade will be entered when the market is moving in the intended direction of the trade. This entry has the advantage of offering the confirmation of momentum with the trade-off that trade location will not be as good. This entry will require larger initial stops compared to entering near support or resistance, and have correspondingly lower reward/risk ratios.

**Setup** This is another variation on the pullback concept; the same setup conditions as in the previous trade apply here.

**Trigger** The difference is the actual entry trigger, which, in this case, is on a breakout of some structure within the pullback itself, usually visible most clearly on a lower



**FIGURE 6.9** A Breakout on the Intraday (Left Pane) Serves as an Entry into the Higher Time Frame Pattern

time frame. Figure 6.9 shows an example in Dendreon Corporation (Nasdaq: DNDN) in which a breakout of resistance on the 78-minute time frame provided a good entry into the pullback on the daily chart. Taken by itself, the breakout on the 78-minute is not a compelling entry—it *is* a valid breakout, but it does not have any supporting factors that make it an exceptional trade. The daily chart provides context for this otherwise unimpressive breakout, and the upward momentum from the intraday time frame transitioned into a larger move on the daily time frame. This is a single example, but the same concept can be applied to any set of properly related time frames: 1-minute/5-minute, 10-minute/30-minute, daily/weekly, or weekly/monthly.

Some traders simplify this approach to merely trading breakouts of the previous bar on the trading time frame. Over a large set of trades, this approach is hit or miss because the high of the trading time frame bar may or may not actually be an important point in the market or on the lower time frame. There is no magic to a breakout of the bar on any time frame, because the chart is simply a representation of the underlying market. In most cases, paying attention to lower time frame price action will allow for cleaner entries, but it is sometimes possible to identify clear support and resistance on

the trading time frame. For instance, if a series of two to three bars all have the same high and all of the other conditions for a good pullback are fulfilled, paying a breakout through those highs is often a good entry. This is perhaps more common intraday, but it also occurs on higher time frames, particularly in liquid markets. It is not, however, common enough to be a bread-and-butter trade; it is more properly understood as a variation of a common pattern.

One other issue to consider on higher time frames is that markets will frequently gap open beyond intended entry points. This happens in all setups, but is particularly common and the gaps may be unusually large in these pullback breakouts. Consider this carefully in your trading plan. Will you skip these entries altogether, wait for a better entry, or enter at whatever price you have to? If you do enter on the gap, will you enter your entire position or perhaps only a partial and look to add the rest at a later point? If you do enter on the opening, will you enter right *on* the opening print, or will you wait for a few minutes' price action to define the opening range? There may not be one right or wrong answer to each question, but some are surely better than others.

**Stop** There are basically two schools of thought on stop placement in these trades. In the case of the lower time frame breakout trigger, many traders will want to use a very tight stop, operating under the assumption that if the breakout is truly a critical tipping point, they can simply exit the market for a very small loss if the anticipated move fails to develop. Furthermore, after booking this very small loss, they will have the freedom to reenter the market multiple times until they finally catch the move they were looking for all along. Traders taking this approach will argue that they are trading a higher time frame pattern with potential reward proportional to the swings on that time frame while using much smaller risk levels from the lower time frame.

Though this is potentially a valid approach in some contexts, it is not usually the best practice. The small losses do add up, and these very tight stops do not respect the reality of the noise level in the market. My preference is to use a larger stop that is true to the geometry of the trading time frame pattern. Yes, there is motivation to have the stop as tight as reasonably possible (because the trade will then support a larger position size, *not* because it is a lower-risk trade), but there is an unavoidable trade-off between reward/risk ratio and probability. Assuming both traders trade consistently, the trader using a tight stop and the trader using the wider stop will have approximately the same expected payoff over a large number of trades. (There is an important lesson there.) In addition, the trader using the very tight stop with the plan to reenter will incur multiple transaction costs (including paying the spread, which is not trivial in some markets or time frames) and runs the ultimate risk of not having the position on when the market finally does make the move.

For traders using very tight stops, position sizing is a serious problem. How many entries will it take until they finally catch the trade? Two? Five? More? Each one of these attempts will incur a loss. If they trade small enough that the losses are insignificant, the winning trades will also be insignificant. If they trade with meaningful size, they will not

be able to enter the same trade very many times. Why play these games when a proper stop can be set that involves less work, lower transaction costs, and better payout?

**Profit Target** The same profit targets apply to all pullback trades.

**Comments** This trade setup addresses the key issue of precisely timing the entry into the pullback pattern. In the best cases, the market will never return to the entry price and the trade will be easy and painless from that point. These cases where the trade works perfectly are a minority, but, even in other cases, the character of the move after the pullback often gives good information about the balance of buying and selling pressure in the market. This combination of a breakout trade nested within a pullback is a powerful tool for discretionary traders on all time frames.

## **TRADING COMPLEX PULLBACKS**

---



### **Trade Type**

Trend continuation.

**Concept** Complex pullbacks, which are pullbacks composed of two distinct countertrend legs, are very common, especially in mature trends. A good understanding of these structures is important, because they will often result in losses for traders who are trading simple pullbacks. Furthermore, many of the best pullbacks—those followed by the strongest, cleanest moves—are complex pullbacks, so a comprehensive trading plan must embrace this pattern.

**Setup** A complex pullback is a complete ABCD trend structure itself: the first countertrend leg is a lower time frame trend (counter to the higher time frame trend), followed by a retracement against the lower time frame trend (i.e., in the direction of the higher time frame trend), which is then followed by another countertrend leg. To actually trade these patterns, traders need to be aware of two distinct forms: one that shows the



**FIGURE 6.10** A Complex Pullback in the EURUSD

Note two clearly visible countertrend legs (AB and CD).

three legs clearly and one that hides them, buried within the lower time frame structure. Figure 6.10 shows a near-perfect example of the first type of complex consolidation that clearly shows three separate legs with an ABCD structure.

There are other cases in which the structure of the complex consolidation is not as clearly visible on the trading time frame. The lower time frame will usually show the distinct trend legs, but they may not be visible on the trading time frame. For experienced traders, it is usually not necessary to explicitly examine the lower time frame, as the structure can usually be inferred from the trading time frame. At first, it may be easiest to recognize this structure on candlestick charts because they better highlight the open-to-close direction within each period. Most candles in pullbacks will be colored against the trend that set up the pullback; that is, pullbacks in uptrends will consist of full candles (red on modern charting packages) and pullbacks in downtrends will usually be empty (green) candles. This second complex pullback pattern is one or two with-trend candles in the middle of what otherwise looks like a simple pullback. The with-trend candle or candles usually represent(s) an aborted attempt to resume the primary trend, and this



**FIGURE 6.11** What Appears to Be a Simple Pullback on the Daily Chart of EURUSD Resolves into a Complex Consolidation on the 120-Minute Time Frame (Inset)

usually hints at a complex pullback hiding under the trading time frame structure. Since some traders will treat moves out of complex pullbacks differently than those out of simple pullbacks, it is important to be able to discern this subtle cue. Figures 6.11 and 6.12 show examples of hidden complex pullbacks.

In a sense, complex pullbacks are nothing more than a category of pullbacks, so all of the conditions for other pullback trades apply here, with one modification. It is usually a good idea to avoid pullbacks after conditions that could indicate a buying or selling climax. We have looked at these parabolic expansions and have seen that they frequently cap trends, so it does not make sense to enter with-trend pullbacks after such a move. Confirmation of the end of the trend is very strong countertrend momentum following such a condition, but market structure can unfold in another way: Rather than shifting into an immediate change of trend, the market can also consolidate and work off the overextension through a more extended consolidation. Normal (simple) pullbacks do this, as they give the market time to pause and digest each trend leg. In the case of a more serious overextension, a larger consolidation is usually required if the trend



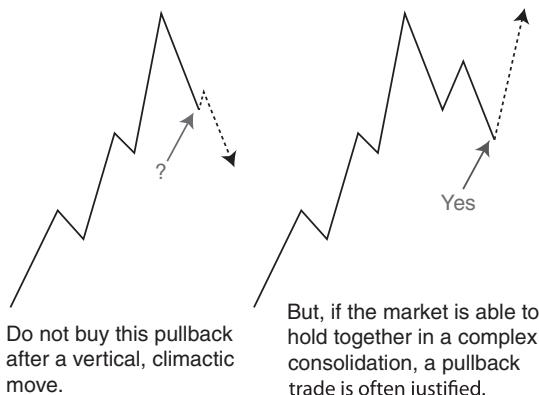
**FIGURE 6.12** A Hidden Complex Pullback in Sugar Futures

This would be a clear complex pullback on an intraday time frame.

is going to continue, and these longer consolidations often take the form of complex consolidations.

If you see a condition that would normally eliminate the possibility of a pullback (e.g., a buying or selling climax), a with-trend trade may still be possible following a complex consolidation in that same area. It is often easier to evaluate the integrity of the trend on the higher time frame, as the trading time frame complex consolidation will usually be a simple consolidation on the higher time frame. Figure 6.13 shows one way a complex consolidation can provide a potential entry after a small buying climax.

**Trigger** Either of the two triggers already discussed for pullbacks—entering at support or on a breakout—are valid for complex consolidations. The support play, especially if backed up by a momentum shift on the lower time frame, is easier in complex consolidations than in simple consolidations because the stop is more clearly established due to the termination of the second pullback leg. In addition, both countertrend legs of the pullback tend to be similar lengths, so it is often possible to predict the general area where the second leg will stop using a measured move objective ( $AB = CD$ ). (This is a



**FIGURE 6.13** Complex Pullbacks Can Provide Entries Where Simple Pullbacks Should Be Avoided

guideline for trends in general, but the market tends to respect this principle even more strongly in pullbacks.)

**Stop** Another advantage of complex consolidations is that the stop level is more clearly defined. In simple consolidations, it is usually a bad idea to set a stop just underneath (for a long position) the consolidation area, but in complex pullbacks this is often an excellent risk point. There certainly are variations of complex pullbacks that have three or more pullbacks, each of which would result in another stop-out, but they are uncommon. The movements out of those also tend to be less reliable, so it does not make sense to make these a focus in the trading plan.

**Profit Target** The same profit targets apply to complex as to simple pullbacks, perhaps with the expectation that a stronger move could develop from a complex consolidation. You might be justified in taking less of your position off at your first profit target, and trying to press more size for a larger move compared to a simple pullback. If you decide to do this, weigh the benefits of having simple rules (e.g., take one-third of your position off at the previous swing) that enforce discipline and consistency against any incremental gains from a more complex approach.

**Comments** One important issue not yet considered is that these complex pullbacks often come following losing trades in simple pullbacks. This creates a risk management question that must be considered. Assume you want to risk \$10,000 on each trade, and you just booked a \$10,000 loss on a simple pullback, which, a few days later, is clearly developing into a complex pullback. What now? There are many possible answers, but it is important to have a clear plan before this situation is encountered. Risk management scenarios deserve careful consideration, planning, and maybe even quantitative modeling—these are not decisions to be made on the fly.